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## WORLD OF FRAUD

### THREE TYPES OF FRAUD

The world of fraud may be defined as a vast aggregation of all the fraud that has occurred in any given time frame. It undoubtedly includes millions of cases of fraud, fraud villains, and fraud victims. It is so vast and so hidden that it defeats any attempt at empirical study. No one can ever know the true nature of fraud with any degree of specificity. Nevertheless, it is possible, by using reasonable conjectures, to estimate its probable makeup. To do so we can begin with the reasonable certainty that all the fraud in the world can be classified as falling into one of only three primary groups.

1. Group 1: Fraud that has been exposed and is in the public domain.
2. Group 2: Fraud that has been discovered by entities, but details have not been made public.
3. Group 3: Fraud that has not been detected.

#### Group 1 Fraud: Exposed and in the Public Domain

Group 1 fraud is the only fraud that we can know with reasonable certainty by virtue of empirical studies. With very few exceptions, this type of fraud has four points in common:

1. Victims have discovered it.
2. It was discovered mostly by accident.
3. Sufficient evidence was gathered to prosecute the perpetrators successfully.
4. The fraud has been submitted to and accepted by prosecutors for prosecution.

Group 1 fraud can be known by anyone who has a serious interest in studying it, due to the fact that normally, during the process of prosecution, details of the fraud cases that prosecutors and defendants chose to release become a part of the public record.

### **Group 2 Fraud: Known by a Few but Not Made Public**

Group 2 fraud is that fraud which has been discovered by victims—in many cases they have little more than suspicions that they may have discovered fraud—and which, with few if any exceptions, is kept confidential by victims. Confidentiality is maintained because any frivolous release of case details that risks identifying a suspected perpetrator or perpetrators also risks defaming them and may be just cause for litigation by injured parties. Generally speaking, the release of case details for purposes other than prosecution could be considered frivolous. In fact, the release of perpetrator-identifying details for purposes of prosecution, where the prosecution results in a finding of not guilty, could be found to be frivolous. Accordingly, often victims are counseled not to seek prosecution where conviction is not reasonably certain.

The second reason why Group 2 fraud is kept confidential is that the cases vary in the degree of evidence that the victim possesses, from faint indications that fraud may have occurred, to an abundance of evidence that leaves little doubt that fraud has occurred. For those cases where there is any question as to the sufficiency of evidence or the suspected perpetrator's involvement, it would be unwise to release publicly any information of the suspected crime. For those cases at the upper end of the spectrum of evidence possessed, and where there are no or few doubts as to the crime or the suspect's guilt, it also would be unwise to publicize case details without good reason, in those instances where busy prosecutors have declined or delayed prosecution. Although some details of a relatively few group 2 fraud cases are accidentally or unwisely revealed from time to time, there is no possible way for anyone to determine the true nature of cases in this group.

### **Group 3 Fraud: Undetected**

Group 3 fraud includes those fraud cases that are known only to the perpetrator(s). Victims do not know or suspect the fraud. Such cases include everything that does not fall into groups 1 and 2. Group 3 fraud cases, by

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definition, can never be known by anyone other than the perpetrator(s). Accordingly, there is no possible way for anyone to determine the true nature of group 3 fraud cases.

## NATURE OF FRAUD

Regardless of the fact that only fraud in group 1 can be studied, a generally accepted view of all fraud—including groups 2 and 3 fraud—has arisen as a result of observations of group 1 fraud. There are four reasons why we can be certain that researchers have accurately determined the true nature of group 1 fraud.

1. The cases in group 1 are available for empirical study.
2. They have been studied many times by different researchers.
3. Experienced fraud auditors and investigators tend to concur with the conclusions.
4. All observations tend to ratify each other.

The findings basically conclude that fraud perpetrators, for the most part, are generally inept and greedy and that most of their crimes are discovered by accident (i.e., no one sets out to discover fraud perpetrators). These latter points also are corroborated. Accordingly, there is no question that the true nature of group 1 fraud is well known. However, group 1 fraud is only one sector of the fraud world. What do we know about groups 2 and 3?

Society has come to accept that the nature of group 1 fraud is typical of all fraud. In other words, it is generally believed that all fraud—with some exceptions, of course—is largely committed by inept and greedy perpetrators, whose ineptness and greed tends to eventually result in their accidental discovery. The problem is very much akin to that made by the six blind men of Indostan and detailed in Exhibit 1.1. The significant difference is that the only part of the fraud world that researchers have to examine is the leg of the elephant, and the entire elephant is being judged by it.

This is a very serious error, a fallacious supposition at the root of two critical decisions made by independent auditors over the years:

1. It is not necessary to audit for the purpose of discovering fraud.
2. Good accounting records and internal control are sufficient to control fraud.

## Exhibit 1.1 The Blind Man and the Elephant

A Version of the Famous Indian Legend  
By John Godfrey Saxe  
(1816–1887)

It was six men of Indostan  
To learning much inclined,  
Who went to see the elephant  
(Though all of them were blind),  
That each by observation  
Might satisfy his mind.

The First approached the Elephant,  
And happening to fall  
Against his broad and sturdy side,  
At once began to bawl:  
“Bless me! But the Elephant  
Is very like a wall!”

The Second, feeling of the tusk,  
Cried, “Ho what have we here,  
So round and smooth and sharp?  
To me ’tis mighty clear  
The wonder of an Elephant  
Is very like a spear!”

The Third approached the animal,  
And happening to take  
This squirming trunk within his hands,  
Thus boldly up and spake:  
“I see,” quoth he, “the Elephant  
Is very like a snake!”

The Fourth reached out his eager hand,  
And felt about the knee.  
“What most this wondrous beast is like  
Is mighty plain,” quoth he;  
’Tis clear enough the Elephants  
Is very like a tree!”

The Fifth, who chanced to touch the ear,  
Said, “E’en the blindest man  
Can tell what this resembles most;  
Deny the fact who can,  
This marvel of an Elephant  
Is very like a fan!”

The Sixth no sooner had begun  
About the beast to grope,  
Than, seizing on his swinging tail  
That fell within his scope,  
“I see,” quoth he, “the Elephant  
Is very like a rope!”

And so these men of Indostan  
Disputed loud and long,  
Each in his own opinion  
Exceeding stiff and strong,  
Though each was partly in the right,  
And all were in the wrong!

This text describes fraud of a different nature. It accepts the current view of fraud for cases in group 1 but submits that fraud in groups 2 and 3 is perpetrated by cunning and conservative perpetrators who do not make the mistakes that lead to self-disclosure. This point illustrates how a given finding of fact can be interpreted differently.

In the past, users of data developed by fraud researchers—who determined that the fraud they examined was committed largely by inept and greedy perpetrators whose mistakes often led to self-disclosure—concluded that the unseen portion of the fraud world contained fraud of the same nature. Accordingly, they tended to assume that fraud was not an invidious threat. They believed that doing nothing would allow those inept and careless perpetrators to make the mistakes leading to their discovery.

Contrary to this generally accepted view, this text takes the position that it is unreasonable to conclude that perpetrators of fraud who have not been discovered will be similarly inept and greedy. Hence, it is unreasonable to conclude that their acts will also be self-revealing. Rather, they are the hardcore remainder left after the inept and greedy have been discov-

## PERCENTAGE OF GROUP 1 FRAUD

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ered. It is this remainder that comprises group 2 and group 3 fraud, and which will require proactive detection practices to disclose it. Were the latter conclusion generally adopted, rather than the first, society would have been motivated to take much more aggressive measures to combat fraud than it did. And, had the latter conclusion been reached, businesses would very likely not have the serious fraud problem that exists today and would not have lost huge amounts of money that most surely has been lost to fraud.

## PROBABLE CONFIGURATION OF THE FRAUD WORLD

It is difficult to know how much group 2 and group 3 fraud exists. However, it is possible to approximate the fraud that we cannot see or otherwise know with certainty. It has been estimated that the fraud world can be broken down into the following percentages:

### Makeup of the Fraud World

Group 1 fraud:	20 percent
Group 2 fraud:	40 percent
Group 3 fraud:	40 percent

The significance of these percentages, if only reasonably accurate, is that society's appraisal of the total fraud threat is based on only 20 percent of all fraud. Further, this text's assertion that the group 1 fraud is atypical of the remaining 80 percent strongly suggests the frightening notion that the tail is wagging the dog and is resulting in significant harm in the process.

## PERCENTAGE OF GROUP 1 FRAUD

The process of estimating the relative percentages of the groups of fraud must necessarily begin with the only group of fraud on which we have reliable knowledge—group 1. From that knowledge it is estimated that group 1 fraud is about 20 percent of the fraud world. Before reviewing how that percentage is arrived at, let it be recognized that 20 percent is not considered an absolute figure. It could easily vary 5 percent either way. Regardless, the point is that whether group 1 fraud makes up 15 percent or 25 percent of total fraud, it comprises only a minority share of the fraud world.

There are five reasons why group 1 fraud is considered to be only about 20 percent of the fraud world:

1. Most of the fraud in group 1 has been discovered by accident.
2. Independent auditors do not proactively audit to detect fraud.
3. Entities without internal audit staffs can not audit to detect fraud proactively.
4. Most internal auditors do not have adequate training or experience to detect fraud proactively.
5. Most internal controls are inadequate to prevent fraud.

Accepting for the moment that these points are factual (they will be discussed more comprehensively in the text which immediately follows), what percentage of all fraud is group 1 fraud likely to be? In other words, consider the low probability of group 1 fraud being greater than 20 percent of all fraud when 80 percent of it has been discovered by accident, in an environment where no one is competently searching for it, and where internal controls are generally not fraud-specific. Consider the likely probability that only the greedy and incompetent perpetrators are being discovered.

### **Largely Discovered by Accident**

A maxim in the auditing profession is “Most frauds are discovered by accident, not by audit or accounting system design.”<sup>1</sup>

In a recent article, Joseph T. Wells said that “Most fraud cases are discovered by accident.”<sup>2</sup> He also quoted a study by W. Stephen Albrecht, an accounting professor at Brigham Young University, and then president of the National Association of Certified Fraud Examiners (NACFE), who reported that one-half of all frauds were discovered by accident, one-third come from coworker complaints—which could also be classified as accidental discoveries—with about one-fifth coming from audit discoveries. It is unknown how many of the auditors’ discoveries were accidental.

Also, in that article, items 2, 3, and 4, listed as generally accepted facts, are consistent with and explain why it is that 80 percent or more of all fraud cases are discovered by accident. The old axiom that you do not discover what you do not look for was never more applicable. Case Study 1.1 shows the typical fraud that makes up group 1.

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### **CASE 1.1 \$3.28 Million Embezzled Over 9 Years—Discovered When Savings Bank Alerted Victim of Suspicious Transactions**

A Maryland woman, on a salary of \$36,000 a year, embezzled \$3.28 million from a union general fund over a period of nine years before union officials became suspicious in 1995 when a credit union notified union officials that large sums of money were moving in and out of union accounts. She had been responsible for transferring employee automatic payroll deductions to a credit union. She was required to issue one check to the credit union each pay period to cover all the employee deductions, to be credited to each employee's credit union account. Her scheme involved writing a larger check than was necessary and keeping the excess. The inflated amounts were as high as \$50,000 in excess. She was able to cover the fraud by falsifying financial records and was also responsible for assuring that the accounts were in balance.<sup>3</sup>

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### **Lack of Proactive Fraud Auditing**

The fact that independent auditors do not audit proactively to detect fraud will not be discussed at length here but will be in Chapter 2. However, the following excerpts taken from AICPA literature leave little doubt as to the factual nature of this statement: "The ordinary examination incident to the issuance of an opinion respecting financial statements is not designed and cannot be relied upon to disclose defalcations and other similar irregularities. . . . If an auditor were to discover defalcations and other similar irregularities he would have to extend his work to a point where its cost would be prohibitive."<sup>4</sup>

"8. Normally, an audit performed in accordance with generally accepted auditing standards does not include audit procedures specifically designed to detect illegal acts."<sup>5</sup>

Most internal auditors do not have adequate training or experience to proactively detect fraud. While many are intensely interested in proactive fraud-specific auditing, it is difficult for them to become proficient in the art. The independent auditing community provides no leadership or guidance. And, since many internal auditors come from the independent auditor ranks, they bring no fraud auditing expertise with them. Few training

sources are capable of providing proactive training. And without an active practice of proactive fraud-specific auditing, there is little opportunity for learning on the job. Due to the general complacency of entities at risk, often insufficient resources are made available to internal auditors for proactive fraud-specific examinations. And, last but not least, given the limited resources that may be available to internal auditors for proactive fraud-specific examinations, any failure to disclose fraud often is regarded as evidence of the nonexistence of fraud rather than the failure to allocate sufficient trained resources. It is frustrating for internal auditors to see their employers not think twice in spending money on fire insurance, and hope there is never a fire, yet question the value of fraud-specific auditing when no fraud is disclosed.

### Inadequate Internal Controls

Internal controls tend to be designed primarily to ensure that accounting records are accurate—to ensure, for example, that all accounting documents applicable to an accounting period have been processed, and processed correctly. Although many internal controls deny access to accounting systems by unauthorized users, without fraud-auditing reinforcement, existing internal controls usually are not a deterrent to dedicated fraud perpetrators. In fact, few internal controls are effective in preventing fraud when two or more perpetrators conspire to evade them. For a more extensive discussion on internal controls—including fraud-specific controls and the more fraud-effective passive controls—please see the second edition of *Accountant's Guide to Fraud Detection and Control*.<sup>6</sup>

At this point, each reader is asked to reconsider what percentage of all the fraud that is in the fraud world is likely to be in group 1. Consider the serious consequences that a fraud perpetrator faces should his or her fraudulent act be discovered and how many perpetrators are apt to be so inept that they leave evidence trails that not only cause them to be discovered *by accident*—by people not looking for their crimes—but evidence in such abundance that prosecution is possible. Consider the precautions you would take were you to seriously consider committing a fraudulent act. Would you say the percentage is 10 percent of all perpetrators are so reckless that they do not carefully plot out their crimes? 20 percent? 30 percent? or higher? How many perpetrators would you think are so inept that they make the sort of mistakes illustrated in Case 1.2?



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## CASE 1.2 The Arrogant Kickback Solicitor

The case began one day when a building security system contractor, a Mr. Johnson, walked into the office of the director of auditing of a major government agency, opened a small suitcase he was carrying, and set a number of cans of health foods on the desk. He then told how he came to have those articles.

He explained that he had gone to New York to submit his bid to install a new security system in a federal building. The first night in New York, while in his hotel room, there was a knock at the door. He opened it to find an elderly woman carrying two full shopping bags. She introduced herself as a Mrs. Smith, emphasizing that she was the mother-in-law of Mr. Jones, the man he would have to deal with to get his security system contract the next day. She emphasized that things would go better for him the next day if he were to buy her health foods. He bought the entire contents of both bags with all the cash he carried (several hundred dollars).

Mr. Johnson went on to describe what happened when he met with her son-in-law, Mr. Jones, the next day. Despite the fact that the contract was outwardly competitive, Mr. Jones said Mr. Johnson could count on getting the contract if he gave him, Mr. Jones, 10 percent of the total contract value. The total price bid by Mr. Johnson was \$50,000. Mr. Johnson told him that the 10 percent kickback would be a problem. He said that to gain entry into government contracting, he had reduced his price offer to the very minimum and anticipated making no profit as it was. A \$5,000 kickback would certainly be a total loss for him.

Mr. Jones was unsympathetic with his explanation. He replied that this contract could be the start of a very prosperous relationship. Mr. Johnson, he replied, should keep in mind that in future contracts, he would be allowed to build the 10 percent kickback amount into the total price he offered, and be assured that he would win many awards.

Mr. Johnson said that he would think about it and returned to his home in a Washington, DC, suburb. Shortly after returning home Mr. Jones called him and said that he and his family were planning to visit Washington, DC, and would like Mr. Johnson to arrange for his transportation, hotel accommodations, meals, and other miscellaneous needs. Mr. Johnson complied, picking up the cost of the Jones family's entire trip.

When Mr. Jones made other similar requests for gratuities, Mr. Johnson decided he had had enough and visited the director of audits to tell this tale.

The auditor referred Mr. Johnson's disclosures to the agency's criminal investigative office, which compiled the evidence needed to prosecute Mr. Jones. The evidence package included a tape recording of Mr. Jones's proposition to Mr. Johnson.

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What percentage of similarly inept fraud perpetrators did you come up with?

This author estimates that 20 percent of all fraud is in group 1. Estimates 5 percent either way do not materially affect the argument that there is a significant body of fraud in groups 2 and 3 that is not available to public scrutiny. If you estimated that group 1 fraud is greater than 25 percent, the author would like to hear from you, together with your reasons. The author may be contacted by writing to: Howard R. Davia, CPA, 347 Warren Court, Warrenton, VA 20186.

### PERCENTAGE OF FRAUD IN GROUPS 2 AND 3

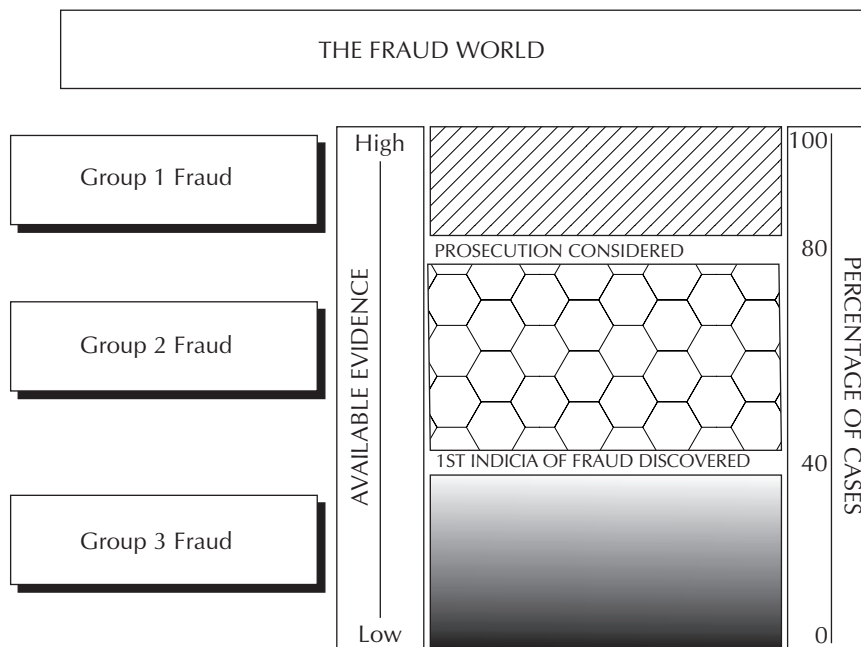
Once a percentage is decided on as reasonably representing group 1 fraud, obviously the combined percentage of groups 2 and 3 fraud makes up the balance. If 20 percent is accepted as the probable relative size of group 1, then it follows that groups 2 and 3 must be 80 percent. Next, having established the combined relative size of groups 2 and 3, it is reasonably logical to divide the amount into two equal groups. If the combined size is 80 percent, then the size of group 2 is 40 percent and group 3 is 40 percent.

If the millions of fraud cases that comprise fraud groups 2 and 3 were arranged according to the amount of evidence which exists and could be detected—note that this does not mean that the evidence that has been detected—it is logical to assume that they would form an evenly progressive array of fraud cases ranging from the 0 evidence cases at the bottom of group 3 to the 100 percent evidence cases at the top of group 2. (See Exhibit 1.2.) Accordingly, the question arises: At what point in that array of cases does the first detection of indicia occur that raise a suspicion of fraud? Of course, no one will ever know for sure. But it seems reasonable—at least for our purposes—to assume that recognition occurs at the halfway point. Once again, indicia recognition could occur at a point 10 percent either way. But, in the absence of more defining data, an even split

## PERCENTAGE OF FRAUD IN GROUPS 2 AND 3

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### Exhibit 1.2 The Fraud World



of groups 2 and 3 fraud suffices. However, it is tempting to make the distribution skewed more to favor group 3 fraud. Consider, for example, how many fraud cases there are which go undetected without a clue for many years, such as in Case 1.3.

### CASE 1.3 The Protracted Payroll Fraud

Accidentally discovered in Maryland in 1997, the case involved a woman who was employed by the University of Maryland for 20 years. She embezzled \$158,000 from the university over a period of seven years and no one at the university seemed to notice, despite the fact that during the seven years she was active, some of her thefts involved \$149,190 in payroll checks written to ghost employees. The auditors certainly did not suspect her, and it is likely that they were never engaged in fraud-specific audits. She was a highly

respected employee of the university and in 1996 was given the President's Award as the university's most valued employee.

Her luck changed in 1997, however, when postal service inspectors suspected her husband as being involved in a stolen check ring. While searching her residence for evidence of her husband's suspected crime, they found University of Maryland payroll stubs under different names that she had saved. Their suspicions led to detection of her fraud. In a replay of the old story where the farmer locked the door to the barn after his horse was stolen, the university tightened payroll procedures.

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If all of the cases in the fraud world could be represented by a simple statistical chart in terms of the discoverable evidence of each crime, they would form a chart such as that depicted by Exhibit 1.2. Note that as evidence increases, so does the discovery rate.

Bear in mind that the divisions between the fraud groups represent decision or recognition points. That is, the area between groups 2 and 3 fraud represents the point at which victims have discovered sufficient evidence that they recognize—or at least suspect—that they may be fraud victims. It is also the point at which their examination efforts tend to change from proactive to reactive. Prior to that point they had no reason to suspect that they had been fraud victims. The area between groups 1 and 2 represents the point at which the victims have accumulated sufficient evidence to know with sufficient certainty that they had been fraud victims to satisfy a prosecutor and may make a decision to prosecute the suspected perpetrators.

## SIGNIFICANCE OF FRAUD UNIVERSE PERCENTAGES

It is worthwhile to contemplate the significance of the 20/40/40 percentages. These percentages are based on a fraud control environment wherein proactive fraud-specific auditing is virtually not practiced and where fraud-specific internal controls are virtually unknown. The fraud that is surfacing is being discovered, for the most part, by accident. Think how those percentages would change when (not if) entities at risk emerge from their complacency and engage independent auditors, and/or employ internal auditors and provide them with the necessary training and experience, and direct them to perform reasonable levels of proactive fraud-specific auditing.

Slowly at first, but then more rapidly, the fraud universe will begin to shrink in size. The increased level of auditing will introduce a higher level of risk for perpetrators that many will find unacceptable. For that reason many will choose not to commit the frauds they might otherwise have contemplated. The proportions of the fraud universe also will change as auditors acquire improved proactive fraud-specific training and, more important, the necessary experience.

As more auditors become better at their fraud-specific jobs, the number of fraud cases in group 3—known only to the perpetrators—will begin to shrink, through either improved deterrence or detection. Although group 3 frauds will never be eliminated, their proportion could easily shrink to 20 percent of the fraud universe. Also, as auditors become more skilled in collecting the necessary evidence to support prosecution, the size of group 2 fraud—that known but not prosecuted—will diminish as more and more cases are prosecuted successfully. One school of thought holds that many business entities do not prosecute because they wish to avoid the publicity. Although this may be true in a few cases, in the author's experience, most often prosecution was not pursued because the entity did not have sufficient evidence to assure conviction.

## NOTES

1. G. Jack Bologna and Robert J. Lindquist, *Fraud Auditing and Forensic Accounting*, 2nd ed. (New York: John Wiley & Sons, 1995), p. 39.
2. Joseph T. Wells, "Six Common Myths about Fraud," *Journal of Accountancy*, February 1990, pp. 82–88.
3. Todd Shields, "The Lifestyle Was too Good to be True." *Washington Post*, March 2, 1997, pp. B1, B4.
4. American Institute of [Certified Public] Accountants, Statement of Auditing Procedure No. 1, *Extensions of Auditing Procedure 1939*, slightly modified in *Codification of Statements on Auditing Procedure*, 1951, pp. 12–13.
5. American Institute of Certified Public Accountants, *Statement of Auditing Standards 54*, April 1988, p. 3.
6. Howard R. Davia, Patrick C. Coggins, John C. Wideman, and Joseph T. Kasantnin, *Accountant's Guide to Fraud Detection and Control*, 2nd ed. (New York: John Wiley & Sons, 2000).

